Internal Revenue Service

memorandum

CC:PNW:SEA:TL-N-3569-99
KGMedleau

Date: MAR 7 2000

To: Martin Townsend, E:1503 MS A153

From: District Counsel Seattle

Subject: [redacted] - Review of Statutory Notice of Deficiency

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On or around February 22, 2000, you faxed us your informal request that we review a proposed statutory notice of deficiency (SNOD) covering [redacted] calendar tax year [redacted] and proposing a deficiency in its Federal income taxes in the amount of $[redacted] The deficiency results from the Service's disallowance of: (1) [redacted]'s entire claimed bad debt expense of $[redacted] for its commercial loans under the conformity election in the section 166 regulations; (2) $[redacted] of [redacted]'s claimed deduction of $[redacted] for the aviation expenses incurred in its use of a corporate jet; and (3) [redacted]'s entire claimed deduction of $[redacted] for the aviation expenses incurred in its use of a Cessna airplane. On February 24, 2000, we also received your fax of the 30-day letter you prepared in connection with the SNOD (but not sent to [redacted] because of the pending expiration of the [redacted] statute of limitations on [redacted].

On March 1, 2000, Bill Boulet (S&L ISP Counsel) and I met with you and Bob Stokes to discuss the proposed disallowance of the bad debt deduction. As we discussed and agreed, the facts in the administrative file indicate that [redacted]'s bad debt deduction comports with its conformity election and that the Service's proposed

adjustment is not sustainable. Thus, we do not concur with the proposed disallowance of [redacted]s claimed bad debt deduction.

As for the proposed disallowance of a portion of the corporate jet and all of the Cessna aircraft aviation claimed expenses, we concur that [redacted] is not entitled to deduct the aviation costs related to the personal use of the airplanes. However, given the time constraints of the statute of limitations expiring and our limited and cursory review of the underlying administrative files relating to these proposed adjustments, we were unable to ascertain the extent of the business vs. personal use of the two airplanes. In addition, we recommend that the SNOD language reflect that the $[redacted] proposed adjustment for the corporate jet expenses took into account the portion of the jet's personal use that was treated and reported by [redacted] as wages to its controlled employees includible in their gross income and, thus, deductible to that extent by [redacted].

Accordingly, we are closing our files in this matter concerning [redacted]s [redacted] tax year as of this date. The rationale for our legal conclusion (which is somewhat abbreviated due to the time constraints) and recommendation, as well as our understanding of the facts upon which they are based, are set forth below.

FACTS

Bad Debt Expense

[redacted]s an accrual basis taxpayer engaged in the business of banking. [redacted] made an election in [redacted] to write off its bad debts under the section 166 conformity election regulations (Treas. Reg. §1.166-2(d)(3)). Prior to this election, [redacted] wrote off its bad debts under the specific charge off method under the section 166 regulations (*i.e.*, writing off the bad debts as they actually became worthless and uncollectible).

At the end of its [redacted] tax year, [redacted]'s assets totaled approximately $[redacted] and its outstanding loans totaled approximately $[redacted] ($[redacted] in commercial loans; $[redacted] in real estate loans; $[redacted] in consumer loans and $[redacted] in other loans). [redacted]s reserve for loan losses at the end of [redacted] was $[redacted] (or [redacted]% of its total loans). For [redacted] pursuant to its conformity election, [redacted] expensed for both financial statement and tax purposes $[redacted] for loan asset losses. Of this amount, $[redacted] was attributable to its commercial loans and $[redacted] of this amount was attributable to one customer and his related corporations (collectively "Debtor" and "Loan"). The bank documents for Debtor indicate that a partial write-off was done in order to bring the Loan's balance down to between $[redacted]- $[redacted] the estimated value of the collateral securing the Loan.

Under the conformity election, debts charged-off in whole or in part for regulatory purposes during a taxable year are presumed to be worthless for federal income tax purposes provided the charge off either (1) results from a specific order of the bank's regulatory authority (the Office of Comptroller or Currency - OCC) or (2) corresponds to the bank's classification of the debt as a loss asset. [redacted] established internal procedures to quality grade its loans.

Pursuant to [redacted] procedure and OCC guidelines, [redacted]s commercial loans were (are) quality graded (QG) by [redacted] account officers according as follows: (1) QG-4 Loans with more than average risk (which corresponds to Federal Classification "Other Loans Especially Mentioned"); (2) QG-5 Below average loans containing actual credit weakness of a continuing well-defined nature (which corresponds to Federal Classification "Substandard"); (3) QG-6 Loans clearly unsatisfactory with a high likelihood of loss (which corresponds to Federal Classification "Doubtful") and (4) QG-7 Considered uncollectible and therefore, a loss (which corresponds to Federal Classification "Loss").

[redacted]s procedure guidelines call for Lending Officers to reclassify the quality grade of any loan determined to be a charge-off or charge-down to QG-7 (loss asset) prior to charging the loan off as a bad debt. However, if the loan has not already been identified as a problem loan, the guidelines permit an immediate down grade to QG-7 at the time the loss is recognized (and written off [redacted]s books). In order to charge off a loan (totally or in part), the account officer must prepare a Request for Loan Charge-Off and have the request approved by the branches' senior lending officer and the Senior Loan Administrator (*i.e.*, Board approval). Regarding the $[redacted] in commercial loans charged off as bad debts in [redacted] the procedure for an immediate down grade to QG-7 was followed in every instance -- *i.e.*, a Request for Loan Charge-Off was prepared and approved by the branches' senior lending officer and the Senior Loan Administrator.

[redacted] graded its loans in conformity with OCC requirements and has received express determination letters confirming its classification method. The express determination letters dated [redacted] and [redacted] both state in relevant part that "[b]ased on our review, we concluded that the bank, as of that date [redacted], and [redacted], maintained and applied loan loss classification standards that were consistent with regulatory standards regarding loan charge-offs."

Aviation Expenses

[redacted] owns a Cessna airplane and a corporate jet. Examination (Exam) determined that the Cessna airplane was not used for business purposes during [redacted] Exam also determined that, based on total flight hours, the corporate jet was used approximately

[redacted]% for business purposes during [redacted] and that the other [redacted]% of use was primarily for the personal benefit of certain officer-shareholders who were "controlled employees" within the meaning of Treas. Reg. § 1.61-21(g).

For federal income tax purposes, [redacted] treated the expenditures allocable to the use of its Cessna airplane and corporate jet as if all of the flights were undertaken for business purposes. That is, [redacted] deducted its total expenditures allocable to the aircrafts, $[redacted] for the Cessna and $[redacted] for the jet. In addition, [redacted] determined the value under Treas. Reg. § 1.61-21(g) of the [redacted] corporate jet flights undertaken for the personal benefit of certain officer-shareholders who were "controlled employees" to be $[redacted] treated this amount as compensation to the officer-shareholders and included this amount in their respective wages on the [redacted] Form W-2 issued to them by [redacted] for income tax withholding purposes.

LAW and ANALYSIS

Bad Debt Deductions

Section 166 and the regulations thereunder allow a deduction for a business debt that becomes wholly or partially worthless within the taxable year, if certain requirements are met. All pertinent evidence, including the value of any collateral securing the debt and the financial condition of the debtor, generally is taken into account in determining worthlessness. *See* Treas. Reg. §1.166-2(a).

However, if a bank makes a valid conformity election, a debt is conclusively presumed to be worthless, in whole or in part, during that year if the debt is charged off, in whole or in part, for regulatory purposes pursuant to a specific order of the bank's supervisory authority. *See* Treas. Reg. §1.166-2(d)(3)(ii)(A)(1). Alternatively, a debt is conclusively presumed to be worthless, in whole or in part, during that year, if the charge-off corresponds to the bank's classification of the debt, in whole or in part, as a loss asset. *Id.* A "loss asset" is defined to mean a debt that is assigned to a class that corresponds to a loss asset classification under standards set forth by the appropriate regulatory authority. *See* Treas. Reg. §1.166-2(d)(3)(ii)(C).

Additionally, in order to avail itself of the presumption of worthlessness pursuant to the conformity election, the bank must meet the "express determination requirement." *See* Treas. Reg. §1.166-2(d)(3)(i) and -2(d)(3)(iii)(D). To meet this requirement, "the bank's supervisory authority must have made an express determination... that the bank maintains and applies loan loss classification standards that are consistent with the regulatory standards of that supervisory authority." Treas. Reg. §1.166-2(d)(3)(iii)(D).

Under Treas. Reg. §1.166-2(d)(3)(iv)(D), the Commissioner may revoke a conformity election, but only if: (1) the bank fails to follow the method of accounting prescribed by

the conformity election regulations; or (2) the bank has taken charge-offs and deductions that, under all facts and circumstances existing at the time, were substantially in excess of those warranted by the exercise of reasonable business judgement in applying the regulatory standards of the bank's supervisory authority.

For its [redacted] tax year, [redacted] followed its internal guidelines in downgrading $[redacted] of its $[redacted] in outstanding commercial loans to QG-7 concurrently with its charging off (for both financial and tax purposes) this portion of its commercial loans as loss assets. Accordingly, [redacted] did not carry such loan amounts on its books in category QG-7 for any length of time, since the charge-off to remove a loan from the books typically occurred simultaneous with the Board's decision that a loss must be recognized.

We believe [redacted] graded its loans in conformity with OCC requirements given [redacted] received express determination letters confirming its classification method during [redacted] The express determination letters dated [redacted] and [redacted] both state in relevant part that "[b]ased on our review, we concluded that the bank, as of that date [redacted] and [redacted], maintained and applied loan loss classification standards that were consistent with regulatory standards regarding loan charge-offs." Thus, we believe [redacted] properly charged off $[redacted] in bad debt expense under its conformity election in [redacted]. That is, the $[redacted] bad debt expense meets the conclusive presumption of worthlessness under Treas. Reg. §1.166-2(d)(3)(ii) irrespective of whether such amounts meet the more stringent test of partial or total worthlessness under Treas. Reg. §1.166-2(a). Moreover, the write off appears reasonable in that: (1) it represents [redacted]% of its total commercial loans ($[redacted]/$[redacted]); and (2) the bulk of the $[redacted] represents the partial write down of the Debtor Loan to between $[redacted]- $[redacted] the estimated value of the collateral securing the Loan.

Aviation Expenses

Under section 162, a taxpayer may deduct the ordinary and necessary expenses of carrying on a trade or business, and section 167 allows a deduction for depreciation of property used in a trade or business.[1] However, under section 161, these deductions are subject to the limitations imposed by section 274.

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[1] Section 168 provides the applicable depreciation method, applicable recovery period and applicable convention for use in determining the section 167 depreciation deduction for tangible personal property.

Section 274(a)(1)(A) generally provides that no deduction otherwise allowable shall be allowed for any item with respect to an activity of a type generally considered to constitute entertainment, amusement or recreation. Section 274(a)(1)(B) provides the same deduction disallowance for a facility used in connection with an activity referred to in section 274(a)(1)(A).

Treas. Reg. § 1.274-2(b)(1)(i) provides that the term "entertainment" means any activity of a type generally considered to constitute entertainment, amusement or recreation, such as entertaining on hunting, fishing, vacation and similar trips. Treas. Reg. § 1.274-2(e)(2)(i) defines a facility used in connection with entertainment generally as any item of personal or real property (including airplanes) owned, rented or used by the taxpayer for (or in connection with) entertainment. Expenditures with respect to a facility used in connection with entertainment include depreciation and operating costs. Treas. Reg. § 1.274-2(e)(3)(i).

Treas. Reg. § 1.274-2(b)(1)(iii) provides special definitional rules for expenditures that might be considered paid or incurred either for travel or for entertainment. Generally, such expenditures are considered to be expenditures for entertainment under Treas. Reg. §1.274-2(b)(1)(iii)(a). However, Treas. Reg. §1.274-2(b)(1)(iii)(c) provides this exception:

> (c) Expenditures deemed travel. An expenditure described in (a) of this subdivision shall be deemed to be for travel to which this section does not apply if it is:
>
> (1) With respect to a transportation type facility (such as an automobile or an airplane), even though used on other occasions in connection with an activity of a type generally considered to constitute entertainment, to the extent the facility is used in pursuit of a trade or business for purposes of transportation not in connection with entertainment. (emphasis added).

Section 274(e) also contains specific exceptions to the application of the deduction disallowance rules of section 274(a). Section 274(e)(2) provides for an exception from these rules for expenses for goods, services and facilities, to the extent that the expenses are treated by the taxpayer with respect to the recipient of the entertainment, amusement or recreation as compensation to an employee on the taxpayer's income tax return and as wages to the employee for purposes of withholding of income tax at the source on wages. *See also*, Treas. Reg. § 1.274-2(f)(2)(iii). As an example, Treas. Reg. § 1.274-2(f)(2)(iii)(C) provides that if an employer rewards the employee (and the employee's wife) with an expense-paid vacation trip, the expense is deductible by the employer (if allowable under section 162 and the regulations thereunder) "to the extent the employer treats the expenses as compensation and as wages."

Under section 61(a)(1), fringe benefits are includible in gross income. Treas. Reg. § 1.61-21(g) sets forth the non-commercial flight valuation rule for determining the fringe benefit amount includible in gross income.

We concur that [redacted] is not entitled to deduct the aviation costs related to the personal use of the Cessna aircraft and corporate jet. However, given the time constraints of statute of limitations expiring and our limited and cursory review of the underlying administrative files relating to these proposed adjustments, we were unable to ascertain the extent of the business vs. personal use of the two airplanes. Assuming the facts support treating [redacted]% of the Cessna aircraft and [redacted]% corporate jet use as personal, we suggest the following SNOD language for the corporate jet disallowance to reflect that the $[redacted] proposed adjustment took into account the portion of the personal use that was treated and reported by [redacted] as wages to its controlled employees includible in their gross income and, thus, deductible to that extent by [redacted][2]

	Adjustment
Aviation Expenses - Jet	$[redacted]

Since you could only establish a business use of [redacted]% for this entertainment facility, it's depreciation and operating expenses have been limited to [redacted]% of the total expenses established, increased by the $[redacted] that was treated and reported by you as wage income to certain employees from their use of this entertainment facility.

RECOMMENDATION

The facts in the administrative file indicate that [redacted]s bad debt deduction comports with its conformity election and that the Service's proposed adjustment is not sustainable. Thus, we do not concur with the proposed disallowance of [redacted]s claimed bad debt deduction.

As for the proposed disallowance of a portion of the corporate jet and all of the Cessna aircraft aviation claimed expenses, we concur that [redacted] is not entitled to deduct the aviation costs related to the personal use of the airplanes. However, given the time constraints of the statute of limitations expiring and our limited and cursory review of the underlying administrative files relating to these proposed adjustments, we were unable to ascertain the extent of the business vs. personal use of the two airplanes. In addition, we recommend that the SNOD language reflect that the $[redacted] proposed

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[2] We have no suggested changes for the SNOD language concerning the disallowance of the Cessna aviation expenses.

adjustment for the corporate jet expenses took into account the portion of the jet's personal use that was treated and reported by [redacted] as wages to its controlled employees includible in their gross income and, thus, deductible to that extent by [redacted]

If you have any questions or if we could be of any more assistance, please do not hesitate to call the undersigned at (206) 220-5951.

KEITH G. MEDLEAU
Attorney